

**Summary of Testimony of
Curt L. Hébert, Jr.
Chairman, Federal Energy Regulatory Commission
Before the Subcommittee on Energy and Air Quality
United States House of Representatives
May 1, 2001**

Electricity markets in California and the Western United States are in disarray, with a substantial imbalance of supply and demand. While no one can build generating capacity fast enough to provide adequate supply in these markets this summer, the Electricity Emergency Relief Act contains a range of measures that can help mitigate the problems in these markets.

The Commission recognizes that it, too, must confront these problems to the full extent of its authority. First, we must promote new supply and load reductions. Market prices are sending the right signals to both sellers and buyers (at least those not subject to a rate freeze). Market prices will increase supply, promote delivery, enhance infrastructure and reduce demand, thus correcting the current imbalance. Last week, the Commission adopted a market monitoring and mitigation plan for California consistent with these principles. Among the provisions of that plan, the Commission adopted a market-oriented approach that will produce for real-time sales, in emergency hours, a price that will ensure that customers are adequately protected against unjust and unreasonable rates, but that also provides a safe harbor for California generators. This will allow them to sell above that price if they can justify their costs. It also instituted an investigation into wholesale rates in Western states outside California, and is seeking comment on what other relief may be necessary.

Second, infrastructure improvements are greatly needed throughout the West and especially in California. We must create the appropriate financial incentives to ensure that the transmission system is upgraded and that new natural gas pipelines are built. The Commission has taken action on these issues recently, and is considering additional action.

Third, as recognized in the Electricity Emergency Relief Act, we need a regional transmission organization (RTO) for the West. A West-wide RTO will increase market efficiency and trading opportunities for buyers and sellers throughout the West. Last week, the Commission took major steps toward RTO formation in the West, approving an RTO (including an independent transmission company to own the transmission facilities of six utilities) spanning eight Western states and conditioning its California market monitoring and mitigation plan on the filing of an acceptable RTO proposal by California utilities.

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I. Overview

Mr. Chairman and Members of the Subcommittee:

Thank you for the opportunity to appear here today to discuss the proposed Electricity Emergency Relief Act. I commend the Chairman of this Subcommittee for introducing this bill and holding this hearing today. Electricity markets in California and the Western United States are in disarray, with a substantial imbalance of supply and demand. While no one can build generating capacity fast enough to provide adequate supply in these markets this summer, this bill contains a range of measures that can help mitigate the problems.

The Commission recognizes that it, too, must confront these problems to the full extent of its authority. In this respect, I would like to make three main points and identify the Commission's recent steps addressing these problems.

First, we need to encourage new supply and load reductions. Market prices are sending the right signals to both sellers and buyers (at least those not subject to a rate freeze). Market prices will increase supply, promote delivery, enhance infrastructure and reduce demand, thus correcting the current imbalance. Last week, as described below, the Commission adopted a market monitoring and mitigation plan for California consistent with these principles. Among the provisions of that plan, the Commission adopted a market-

oriented approach that will produce for real-time sales, in emergency hours, a price that will ensure that customers are adequately protected against unjust and unreasonable rates, but that also will provide a safe harbor for California generators. This will allow them to sell above that price if they can justify their costs. It also instituted an investigation into wholesale rates in Western states outside California, and is seeking comment on what other relief may be necessary.

Second, infrastructure improvements are greatly needed throughout the West and especially in California. We need to create the appropriate financial incentives to ensure that the transmission system is upgraded and that new natural gas pipelines are built. The Commission has taken action on these issues recently, and is considering additional action.

Finally, we need a regional transmission organization (RTO) for the West. California is not an island. It depends on generation from outside the State. The shortages and the prices in California have affected the supply and prices in the rest of the West. The Western transmission system is an integrated grid, and buyers and sellers need non-discriminatory access to all transmission facilities in the West. A West-wide RTO will increase market efficiency and trading opportunities for buyers and sellers throughout the West. As described below, the Commission took important steps last week to promote RTO formation in the West.

The Commission's recent actions are an important part of the backdrop for the legislation under consideration today. My testimony begins by describing these actions.

Then, my testimony discusses the sections of the Electricity Emergency Relief Act affecting the Commission's authorities and responsibilities.

II. The Commission's Recent Actions

A. Market Monitoring and Mitigation

1. Action to Help California

In the past few months, the Commission has issued dozens of orders to address dysfunctional wholesale energy markets in California and the West. Just last week, the Commission adopted an innovative plan for market monitoring and mitigation in California. San Diego Gas & Electric Co. v. Sellers of Energy and Ancillary Service, et al., 95 FERC ¶ 61,115 (2001). This plan strikes an appropriate balance by bringing market-oriented price relief to the California electric market, providing greater price certainty to buyers and sellers of electric energy, promoting conservation, and - importantly - simultaneously encouraging investment in generation and transmission.

The Commission established price mitigation for the real-time market run by the California Independent System Operator Corporation (ISO). However, the price mitigation, based on a safe harbor price determined from a market-oriented formula, applies only when California reaches a Stage 1 emergency, i.e., when generating reserves are at or below 7.5 percent.

The price mitigation simulates the price a competitive market would produce. Under the price mitigation, a market-driven price for real-time electricity would be determined each day based on market costs for electricity inputs (natural gas and emission allowances),

and the fuel usage ratio ("heat rate") and emission rate for the least efficient generator needed to meet demand that day. All California generators bidding at or below this market-driven, safe harbor price would be paid this price. Any California generator bidding above this safe harbor price and selected to run by the ISO would be paid its price, subject to refund and justification, but its bid would not raise the safe harbor price.

The price mitigation would apply to marketers as well. A marketer could accept the safe harbor price or specify its own price. If its price exceeds the safe harbor price, the marketer would be required to justify its price based on the amount it paid for power.

This price mitigation plan reflects the way pricing works in competitive markets. As in a competitive market, the price is set by the highest priced supply needed to meet demand. The plan also provides certainty to the market. All bidders below the market price are paid that price, and need not provide subsequent justification.

The plan provides incentives for investments in efficient generation. The market price under this plan is set by the price of the least efficient generating facility used each day. Any new facility will receive this same price. Thus, the more efficient the new facility is, the more it will earn. Conversely, the plan provides incentives for retiring or replacing inefficient, dirtier facilities.

The plan does not set price caps. A price cap is a fixed limit on sellers' prices that does not change over time, i.e., a snapshot. By contrast, the Commission's price mitigation allows prices to vary each day based on market changes in the cost of electricity inputs. Moreover, each generator can bid any amount it chooses, so long as the generator can justify

any bid above the announced market price. For example, if a seller's own gas costs exceed the gas costs used in determining the safe harbor price, the seller can seek to justify the higher costs.

Nor does the plan discourage the sale of generation into California from facilities located outside of California. Out-of-state facilities have no obligation to sell into California. If they do, they can recover any bid, even if in excess of the safe harbor price, that is accepted by the ISO.

The plan contains several other important elements. For example, all jurisdictional sellers with "participating generator agreements (PGAs)" with the ISO must offer all power that is available in real-time and not already scheduled or committed by contract. Other California generators whose sales are not jurisdictional but who sell in the ISO's markets or use the ISO's transmission facilities must do the same as a condition of being able to participate in ISO markets and also a condition of using Commission jurisdictional transmission facilities. In addition, the non-jurisdictional sellers also must agree to abide by the same price mitigation and monitoring that applies to the other generators. These conditions were put in place by the Commission so that all generators -- even those that are not otherwise subject to the Commission's jurisdiction -- participate in helping to solve California's problems. The only exception is for hydroelectric facilities, because of their multi-purpose characteristics (e.g., irrigation, recreation and power production).

Also, all public utilities buying from the ISO must submit "demand bids" identifying the price they are willing to pay for power and the load to curtail if prices exceed that

amount. This requirement will help the ISO's real-time market behave more like a competitive market, where increases in price reduce demand.

The plan enhances the ISO's ability to coordinate and control planned outages. The ISO must submit weekly reports to the Commission on outages and bid data, so that the Commission staff can continue to monitor the market. Further, the Commission modified public utility sellers' market-based rate authority to prohibit anticompetitive bidding behavior in the ISO's real-time market. All of the elements of the plan, with the exception of the safe harbor price, operate 24 hours a day, seven days a week, during the specified duration of the plan.

Finally, the Commission imposed two important limits on its price mitigation plan. First, all of the mitigation terminates not later than one year from now, so that California cannot rely indefinitely on mitigation in lieu of new generation and conservation. Second, all mitigation is conditioned on the ISO and California's three investor-owned utilities filing an acceptable RTO proposal by June 1, 2001. This last point is discussed below with respect to the Commission's effort to encourage development of RTOs.

2. Investigation of Other Real-Time Western Sales

As part of the same order last week, the Commission opened a formal investigation into prices charged by public utilities for real-time wholesale power sales (i.e., up to 24 hours in advance) throughout the West (other than sales through the ISO). The Commission proposed: (1) to mitigate prices charged by all public utilities; and, (2) to impose mitigation as a condition on all non-public utilities using the interstate transmission facilities of public

utilities. Similar to the Commission's approach for the ISO's market, price mitigation here would apply only when contingency reserves fall below 7.0 percent in any control area in the WSCC. The Commission sought comments on what the price mitigation for these sales should be, stating that its intent is to mirror its approach in the ISO's real-time market to the extent possible. The Commission also proposed, as it required in the ISO's market, that generators should have to offer all energy available in real-time. As above, hydroelectric generation would be exempt from the "must-offer" requirement but not from the price mitigation rules.

After receiving and reviewing public comment on its proposal, the Commission will determine the market monitoring and mitigation plan for real-time wholesale sales in the West other than sales through the ISO.

B. Other Commission Efforts to Increase Supply and Reduce Demand

Six weeks ago, the Commission issued an order seeking to increase energy supplies and reduce energy demand in California and the West. Removing Obstacles to Increased Electric Generation and Natural Gas Supply in the Western United States, 94 FERC

¶ 61,272 (2001) ("Order Removing Obstacles"). The Commission implemented several measures immediately, including:

- o streamlining filing and notice requirements for various types of wholesale electric sales, including sales of on-site or backup generation and sales of demand reduction;
- o extending (through December 31, 2001) and broadening regulatory waivers for Qualifying Facilities under the Public Utility Regulatory Policies Act of 1978, enabling those facilities to generate more electricity;

- o expediting the certification of natural gas pipeline projects into California and the West; and,
- o urging all licensees to review their FERC-licensed hydroelectric projects in order to assess the potential for increased generating capacity.

The Commission also proposed, and sought comment on, other measures such as incentive rates and accelerated depreciation for new transmission facilities and natural gas pipeline facilities completed by specified dates, blanket certificates authorizing construction of certain types of natural gas facilities, and greater operating flexibility at hydroelectric projects to increase generation while protecting environmental resources.

The Commission received many comments on these proposals. I expect the Commission to complete its review of these comments and finalize its actions on these issues soon. In addition, the Commission already is acting on many of the initiatives it announced in its Order Removing Obstacles. For example, in the month of April, the Commission significantly expedited its processing of applications - approved in a mere three or four weeks - to add significant amounts of natural gas pipeline capacity to California.

C. A West-wide RTO

The development of a West-wide RTO is vital to preventing future problems in the West. The shortages and prices in California have affected the supply and prices in states throughout the West because the Western transmission system is an integrated grid. A West-wide RTO is critical to support a stable interstate electricity market that will provide buyers and sellers the needed non-discriminatory access to all transmission facilities in the

West. A West-wide RTO will increase market efficiency and trading opportunities for buyers and sellers throughout the West.

Last week, the Commission took major steps toward RTO formation in the West. First, the Commission accepted key parts of a proposal for an RTO that will span eight Western states, RTO West. RTO West will operate (but not own) more than 90 percent of the high voltage transmission facilities from the U.S.-Canadian border to southern Nevada. The Commission said RTO West can serve as a platform for the ultimate formation of a West-wide RTO.

In the same order, the Commission accepted a proposal for an independent transmission company within the RTO West structure, TransConnect. TransConnect will own and operate the transmission facilities of six utilities in the region.

Finally, as noted above, the Commission conditioned its price mitigation in the California ISO's real-time market on the ISO and California's three investor-owned utilities filing an RTO proposal by June 1, 2001, consistent with the characteristics and functions set forth in the Commission's Order No. 2000. As the Commission stated, this condition "recognizes that the only real solution to supply problems that affect the western United States is to create a regional response."

III. Electricity Emergency Relief Act

This proposed legislation contains a number of sections affecting the Commission's authorities and responsibilities. These sections are addressed seriatim below. While my

testimony does not contain suggestions for technical revisions, the Commission's staff can provide such analysis later if you would find the analysis helpful.

Overall, this legislation would improve FERC's ability to respond to the problems in electricity markets in California and other Western States. It represents a welcome legislative response to current market problems in the West. However, the likely extent of the improvement this summer is hard to estimate.

Section 101 would require the Commission to establish a clearinghouse system to facilitate agreements under which wholesale buyers would forego purchasing electric energy that they are entitled to buy under contractual arrangements. The compensation paid for foregone purchases is deemed to meet the requirements of the Federal Power Act. This authority would end on October 1, 2003, except for contracts already executed. The Commission must report to Congress by January 1, 2003, on the section's effect and whether Congress should extend the section's authority.

Section 101 (and **Section 102**, discussed below) reflect a market-driven approach to encouraging conservation. Instead of mandating conservation, these sections provide incentives for consumers to conserve and sell the saved energy at market prices. Consumers will decide how much to conserve by comparing the market price of saved energy to the cost of conservation. While certain states are taking steps toward such programs (and, as explained below, the Commission is respectful of such programs), federal legislation on this issue will ensure a comprehensive program is in place to maximize opportunities for participation.

However, I have two minor reservations as to **Section 101**. First, this section eliminates the Commission's statutory authority to determine whether rates for such arrangements are just, reasonable and not unduly discriminatory or preferential. The Commission should continue to have this authority, at least for purposes of affiliate arrangements. Second, this section eliminates the Commission's authority for establishing a clearinghouse beyond October 1, 2003. However, I believe the Commission already has authority to establish such a clearinghouse under the existing FPA and the new provision could be read as eliminating pre-existing authority. I would be happy to have my staff provide technical language modifications to address this problem.

Section 102 would establish a program allowing any electric consumer of an electric utility in the Western Systems Coordinating Council (WSCC) to sell at market prices the portion of electric load the customer is willing to forego out of the total amount it is entitled to consume. The latter amount is based on the customer's contract, applicable regulation or the amount "the consumer would otherwise reasonably be expected to consume, as determined by the Commission." This program would end on October 1, 2003, except for contracts already executed.

The Commission has some authority to implement, and in fact recently implemented, such a program. Order Removing Obstacles, *supra*, 94 FERC ¶ 61,272. The Commission's program applies to retail and wholesale customers, while the draft legislation would apply to "any electric consumer," a term defined to exclude wholesale customers. However, the Commission's authorization for retail customers is mindful of its limited jurisdiction under

the Federal Power Act and respectful of traditional state jurisdiction over state demand-side initiatives; accordingly, it is effective only "as permitted by state laws and regulations." The Commission's program also imposes certain minimal reporting requirements, to ensure compliance with the Federal Power Act. Finally, the Commission's program ends on December 31, 2001, while the draft legislation's program would continue until October 2003.

Section 103 would require the Secretary of Energy and the Commission to prepare, within six months after the bill's enactment, a study of electric power transmission congestion and a plan to relieve constraints that reduce the efficiency of the transmission grid within various regions and with Canadian and Mexican transmission systems.

Section 107 would prohibit the Commission and other governmental entities from requiring a sale of electric energy or natural gas "unless there is a guarantee that, as determined by the Commission, is sufficient to ensure that the seller will be paid the full purchase price when due."

The Commission's authority to set the rates, terms and conditions of jurisdictional services applies to creditworthiness requirements. The Commission generally does not mandate such requirements, and instead lets sellers address the issue as they see fit, so long as any creditworthiness requirements they propose are just and reasonable. However, the Commission recently has taken action to prevent a weakening of creditworthiness requirements in the markets run by the California ISO. California Independent System Operator Corp., 94 FERC ¶ 61,132, clarification granted and reh'g denied, 95 FERC

¶ 61,026 (2001); California Independent System Operator Corp., 95 FERC ¶ 61,024 (2001).

There, the ISO sought to lower its creditworthiness requirements to allow continued purchases by certain financially-stressed utilities. The Commission said that the ISO's proposal would cause "an inappropriate unilateral shifting of unacceptable financial risks to both large and small third-party suppliers." The Commission also said the proposal would increase prices paid by consumers because sellers would likely add a "risk premium" to their prices.

Accordingly, the Commission rejected the ISO's proposal for purposes of such third-party sales. However, the Commission said sales to the financially-stressed utilities could continue if the utilities arranged adequate credit-support arrangements, and noted that California's Department of Water Resources had provided such support previously.

Section 107 may apply well beyond the scope of the current problems in California and the Western United States and the type of sales ordered several months ago by the former and current Secretaries of Energy. The applicability and effect of this section warrants careful consideration and analysis.

Section 108 provides that, if the State of California or any entity established by the State owns or operates transmission facilities acquired from a Commission-regulated public utility, the State or such entity will be subject to Commission regulation with respect to such facilities to the same extent and in the same manner as would be the public utility itself. This section would ensure that these transmission facilities remain available for use by market participants on an open access, non-discriminatory basis, and also would be subject

to the same RTO rules that apply to public utilities. I believe any disposition of ownership or control of these facilities by the California IOUs or the California ISO to the State of California or a California entity would require Commission approval under existing section 203 of the Federal Power Act, and section 108 would maintain Commission jurisdiction after the disposition.

Section 205 would require the Commission to revise its rules to provide that a qualifying facility under the Public Utility Regulatory Policies Act of 1978 (PURPA) that is not paid for its electric energy when required by contract may sell its energy to another buyer. This section also addresses the need for transmission, interconnection and distribution services to facilitate such alternative sales.

Similar issues are pending before the Commission, and I cannot comment on the merits of those issues based on currently applicable law. These issues also are pending before various courts. I believe that prompt resolution of these issues is critical to freeing up, for immediate sale into California this summer, several thousand megawatts of existing capacity that, I understand, is lying idle because of the inability of California utilities to pay for PURPA capacity. Federal legislation may be the best way to reach a quick and comprehensive resolution.

I can also add that the Commission provided various waivers and authorizations in its Order Removing Obstacles, *supra*, that enhanced the ability of PURPA qualifying facilities to generate electricity above historical levels.

Section 301 requires the Commission to promulgate a standard license article allowing hydroelectric licensees, upon request by the Governor of the affected State, notice to the Commission and consultation with relevant resource agencies, to modify or suspend otherwise applicable license conditions, for up to two years, in order to increase generation in response to a state-declared electric supply, generating, or system reliability emergency.

This section could significantly alter the Commission's existing authority and responsibilities. Under Part I of the Federal Power Act, the Commission (along with federal and state agencies possessing mandatory conditioning authority) currently determines the conditions contained in licenses it issues. Section 301 provides that licensees unilaterally would decide whether to include the new standard condition in their licenses. It also provides that licensees, rather than the Commission, would make the decision to modify or suspend the terms of their licenses, with whatever environmental or safety implications such decisions may entail. Under this scenario, the Commission's role of balancing public interest factors, including power, environmental considerations, and issues such as dam safety, would be disturbed.

Section 301 could, however, allow the Commission's hydroelectric licensees to respond, and respond more quickly, to energy shortfalls by increasing generation, both this summer and in the case of future energy shortages. The Commission recently proposed, to the extent consistent with the existing provisions of the Federal Power Act, allowing for greater operating flexibility at licensed projects to increase generation while protecting environmental resources. Order Removing Obstacles, *supra*, 94 FERC ¶ 61,272.

Section 306 would require the Commission, upon request by at least 10 of 14 Western Governors, to form a West-wide RTO. The Bonneville Power Administration and the Western Area Power Administration would be required to participate, as would each other entity (including municipally owned entities and cooperatives) owning or operating transmission facilities in the WSCC. The RTO would not be required to continue operating for more than three years.

I strongly support the formation of such an RTO. While such action would provide short-term efficiencies and economies in the West, the RTO could continue to provide such benefits well beyond the horizon of the current imbalance of supply and demand. If formed, the RTO should be allowed to cease operations or transfer operational control of transmission facilities to another entity only upon a Commission finding that such action is consistent with the public interest. This requirement applies already to such actions by public utilities under section 203 of the Federal Power Act (as does a requirement for Commission authorization to terminate rate schedules under section 205), and the proposed legislation should be clarified to avoid any ambiguity about its applicability here, too.

IV. Conclusion

The Commission will continue to take steps that, consistent with its authority, can help to ease the present energy situation without jeopardizing longer-term supply solutions. As long as we keep moving toward competitive and regional markets, I am confident that the present energy problems, while serious, can be solved. I am also confident that market-

based solutions offer the most efficient way to move beyond the problems confronting California and the West.

The Electricity Emergency Relief Act is a step in the right direction. While certain provisions in the bill warrant minor revisions, the bill will help mitigate the current imbalance of supply and demand and the problems caused by that imbalance.

Thank you.